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No. 08-916

In the
Supreme Court of the United States

VFJ VENTURES, INC., F/K/A VF JEANSWEAR, INC.,
Petitioner,

v.

G. THOMAS SURTEES, IN HIS OFFICIAL CAPACITY AS COMMISSIONER OF THE DEPARTMENT OF REVENUE FOR THE STATE OF ALABAMA, AND THE ALABAMA DEPARTMENT OF REVENUE,
Respondents.

On Petition for a Writ of Certiorari to the Supreme Court of Alabama

BRIEF OF THE STATE OF DELAWARE AS AMICUS CURIAE IN SUPPORT OF PETITIONER

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TABLE OF CONTENTS

TABLE OF AUTHORITIES ii

INTEREST OF THE AMICUS 1

ARGUMENT 2

I. Alabama's Add-Back Statute Impermissibly Interferes With Delaware's Corporate Tax Policy, Which Is An Integral Component Of The State's Economic Development Program 2

A. Delaware's Tax-Related Economic Development Efforts 3

1. Separate Reporting 3

2. Intangible Property Companies 4

B. The Add-Back Response 6

II. Delaware Is Constitutionally Entitled To Devise And Implement Its Corporate Tax Policies Without Encroachments From Other States 7

III. This Court Should Resolve The Add-Back Issue Now. 11

CONCLUSION 14

TABLE OF AUTHORITIES

Cases

Baldwin v. G.A.F. Seelig, Inc.
294 U.S. 511 (1935) 9

Bigelow v. Virginia
421 U.S. 809 (1975) 8

BMW of North America, Inc. v. Gore
517 U.S. 559 (1996) 8

Bonaparte v. Tax Court
104 U.S. 592 (1881) 8

Brown-Forman Distillers Corp. v. New York State Liquor Auth.
476 U.S. 573 (1986) 9

CTS Corp v. Dynamics Corp. of Am.
481 U.S. 69 (1987) 8

Edgar v. MITE Corp.
457 U.S. 624 (1982) 9

Healy v. Beer Institute
491 U.S. 324 (1989) 8, 9

McKesson Corp. v. Division of Alcoholic Beverages & Tobacco
496 U.S. 18 (1990) 12

New State Ice Co. v. Liebmann
285 U.S. 262 (1932) 7

New York Life Ins. Co. v. Head
234 U.S. 149 (1914) 8

Phillips Petroleum Co. v. Shutts
472 U.S. 797 (1985) 8

Southern Pac. Co. v. Arizona
325 U.S. 761 (1945) 9

State Farm Mut. Auto. Ins. Co. v. Campbell
538 U.S. 408 (2003) 8

Statutes

Ala. Code § 40-18-35 ..... 6, 10

Del. Code Ann. Tit. 10, § 346 3

Del. Code Ann. Tit. 30, § 1902 ..... 3, 4

Del. Code Ann. Tit. 30, § 1903 ..... 4, 6

Del. Code Ann. Tit. 30, § 2061 5

Del. Code Ann. Tit. 30, § 2062 5

Del. Code Ann. Tit. 30, § 2301 5

Del. Code Ann. Tit. 30, § 6402 5

64 Del. Laws c. 461, § 10 (1984) 4

Other Authorities

Delaware Department of Finance, *Delaware Fiscal Notebook* (2008) 5

Delaware Department of State: Division of Corporations http://corp.delaware.gov/aboutagency.shtml 2

Delaware Economic Development Office: Entrepreneurial and Small Business Development http://dedo.delaware.gov/IPprogram.shtml 3

William B. Chandler III & Anthony A. Rickey, *Manufacturing Mystery: A Response To Professors Carney and Shepherd's "The Mystery of Delaware Law's Continuing Success"* 2009 U. Ill. L. Rev. 95 (2009).....2

Jerome R. Hellerstein & Walter Hellerstein, *State Taxation* ¶ 8.11 (3d ed. 1998 & Supp. 2008).....4

Donald F. Parsons, *et al.*, *Solving the Mystery of Patentees' "Collective Enthusiasm" for Delaware* 7 Del. L. Rev. 145 (2004).....6

INTEREST OF THE AMICUS

Although not a named party, Delaware's sovereign interests are at the heart of this case.[1] Delaware is a small state, in terms of both geography and population. To compete in the national marketplace, Delaware has made numerous policy judgments aimed at encouraging businesses to locate within its borders. One of those choices has been to adopt a series of laws that give favorable tax treatment to companies that manage intangible property in Delaware.

Alabama's disagreement with Delaware's tax policy is clear. Rather than use constitutionally permissible means to compete with Delaware for business, Alabama has chosen, by enacting the "add-back" statute at issue here, to reach across Delaware's borders and attempt to nullify Delaware law. Alabama's add-back statute requires Alabama companies calculating their Alabama corporate income taxes to "add back" intangibles-related royalty payments that they make to Delaware corporations. By exercising its taxing power extraterritorially, Alabama has eliminated one of the tax advantages that Delaware's General Assembly chose to make available to its corporate citizens. By doing so, Alabama has, in effect, enacted the very sort of interstate tariff that the Constitution and this Court's jurisprudence have sought to prevent.

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[1] Pursuant to Supreme Court Rule 37.2, Delaware represents that "counsel of record for all parties receive[d] notice of its intention to file an *amicus curiae* brief at least 10 days prior to the due date for the *amicus curiae* brief."

Alabama's add-back statute, unfortunately, is one among many; 18 other jurisdictions have enacted similar measures. Those statutes' practical impact on Delaware's carefully considered policy choices cannot be fully appreciated until this Court definitively determines whether they violate the Constitution. Because Delaware has a keen interest in the prompt vindication of its policy choices—and, frankly, in clarity for its own sake—it urges this Court to grant the petition and decide the questions presented.

ARGUMENT

I. Alabama's Add-Back Statute Impermissibly Interferes With Delaware's Corporate Tax Policy, Which Is An Integral Component Of The State's Economic Development Program.

Delaware has a long history and a recognized identity as a leader and an innovator in both tax policy and corporation law. Delaware's innovations in those areas have been—and continue to be—essential to Delaware's successful economic development and business recruitment strategies. Despite having a population of fewer than a million people and being the second smallest state in the country geographically, more than 50% of all publicly-traded companies in the United States—including 63% of the Fortune 500—have chosen to incorporate in Delaware. *See, e.g.*, William B. Chandler III & Anthony A. Rickey, *Manufacturing Mystery: A Response To Professors Carney and Shepherd's "The Mystery of Delaware Law's Continuing Success,"* 2009 U. Ill. L. Rev. 95, 99 (2009); Delaware Dep't of State: Division of Corporations, http://corp.delaware.gov/aboutagency.shtml (visited Feb. 13, 2009).

Delaware has long appreciated the evolving nature of the American economy and, in particular, the need to develop the emerging technology and intellectual property industries. Accordingly, it has launched initiatives designed to make the state attractive to high-tech and knowledge-based businesses. Delaware's more notable efforts include the innovative Intellectual Property Business Creation Program, *see* Delaware Economic Development Office: Entrepreneurial and Small Business Development, http://dedo.delaware.gov/IPprogram.shtml (visited Feb. 13, 2009), and recent legislation enabling the state's Court of Chancery to mediate "technology disputes," *see* Del. Code Ann. Tit. 10, § 346.

A key component of Delaware's economic development strategy is its corporate tax policy, several features of which are designed specifically to attract business to the state and, as particularly relevant here, to benefit companies engaged in the management of intangible assets and investments. "Add-back" statutes like Alabama's constitute an unconstitutional assault on Delaware's tax-related policy judgments and business development initiatives.

A. Delaware's Tax-Related Economic Development Efforts

1. Separate Reporting

Delaware, like Alabama, is a "separate return" state. *See* Del. Code Ann. Tit. 30, § 1902(a). This means that Delaware does not tax business entities without nexus to the state, even if those entities engage in a unitary business with companies that do operate in Delaware. Separate reporting gives corporate groups the flexibility to order their affairs so that income earned by affiliates in

other states is not taxed in Delaware. *See, e.g.*, Jerome R. Hellerstein & Walter Hellerstein, *State Taxation* ¶ 8.11 (3d ed. 1998 & Supp. 2008). In addition, business entities in Delaware receive state tax deductions for amounts paid to related out-of-state companies. *See* Del. Code Ann. Tit. 30, §§ 1902(a), 1903(a). Delaware has consistently applied separate reporting principles and has not attempted, by way of an add-back statute or otherwise, to reach across state lines and effectively undermine or disregard the legal separateness of corporate entities.

2. Intangible Property Companies

In 1984, Delaware clarified the scope of a corporate income tax exemption for companies that specialize in managing intangible property. *See* 64 Del. Laws c. 461, § 10 (1984). These corporations—often called intangibles holding companies, or "IHCs"—are exempt from Delaware corporate income tax so long as they limit their Delaware activities as provided by statute. *See* Del. Code Ann. Tit. 30, § 1902(b)(8).[2]

The H.D. Lee Company, Inc. and Wrangler Apparel Corp. (hereinafter, "Lee" and "Wrangler," respectively) are Delaware corporations that manage intangible property for the Petitioner (Pet. 2) and, accordingly, pay no

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[2] To earn tax-exempt status, IHCs must limit their activities to the following: "the maintenance and management of their intangible investments or of the intangible investments of corporations or statutory trusts or business trusts registered as investment companies under the Investment Company Act of 1940, as amended (15 U.S.C. 80a-1 *et seq.*) and the collection and distribution of the income from such investments or from tangible property physically located outside this State." Del. Code Ann. Tit. 30, § 1902(b)(8).

Delaware corporate income tax. Lee and Wrangler are also exempt from the state annual license fee and gross receipts tax. *See* Del. Code Ann. Tit. 30, § 2301(o).

These exemptions advance Delaware's considered policy decision to encourage IHCs to locate in-state. That policy is eminently sensible. IHCs like Lee and Wrangler (1) provide jobs with competitive compensation for Delaware citizens; (2) create business for Delaware service-providers, including accountants, lawyers, and specialized administrative support personnel; and (3) do so with only minimal impact on Delaware's environment and infrastructure. Moreover, although the IHCs themselves do not pay corporate income taxes, they generate additional revenue for the state through the income and other taxes paid by their employees and service providers. This tradeoff between corporate and individual income taxes is one that Delaware has made purposefully, and this reasoned policy choice has benefited Delaware accordingly. *See* Delaware Department of Finance, *Delaware Fiscal Notebook* 25 (2008) (showing that Delaware derives only about 5% of its tax revenues from corporate income tax, compared to 30% from personal income tax).[3]

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[3] Delaware has chosen to give favorable tax treatment to two other types of entities that manage intangible property: headquarters management corporations ("HMCs") and asset management companies ("AMCs"). Both have somewhat more flexibility than IHCs with respect to the range of services they offer, but neither is completely exempt from corporate income tax. HMCs' income is taxable, but they are able to take advantage of tax credits (designed specifically for them) that often reduce their tax to the $5,000 minimum. *See* Del. Code Ann. Tit. 30, §§ 2061, 2062, 6402. AMCs are entitled to apportion intangibles income based on the location of their "sales" rather than their property or employees; because many

B. The Add-Back Response

Delaware's corporate tax code embodies the state's considered policy of encouraging companies involved in the management of intellectual and other intangible property to locate in-state. Delaware's efforts in this regard have been successful, and Delaware has become a leading intellectual property center, home to hundreds of IHCs. *See, e.g.*, Donald F. Parsons, *et al.*, *Solving the Mystery of Patentees' "Collective Enthusiasm" for Delaware*, 7 Del. L. Rev. 145 (2004).

Other states have responded in various ways to Delaware's efforts to foster the growth of the intellectual-property management industry. Some states have chosen to compete through constitutionally permissible means by imposing lower taxes or granting tax incentives. Delaware welcomes that sort of friendly competition, which represents the best of the federal system.

Alabama, unfortunately, has chosen a different—and constitutionally impermissible—course. It passed an "add-back" statute, *see* Ala. Code § 40-18-35(b), that effectively penalizes Alabama taxpayers who choose to locate their intangible property affiliates in Delaware. The Petitioner has explained the add-back statute's operation. It is sufficient for present purposes to note that Alabama's add-back statute is structured such that (1) if an Alabama taxpayer pays royalties to a related corporation *in Delaware*, it will owe Alabama tax on those royalties but (2) if the Alabama company instead pays those royal-

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of an AMC's customers will be located out-of-state, a significant portion of its income will not be subject to Delaware tax. *See id.* § 1903(b)(7).

ties to a related corporation in Alabama (or Georgia, or some other taxing jurisdiction), it will owe no additional Alabama tax. *See* Pet. 16-17. On its face, therefore, Alabama's add-back statute is—like the similar provisions in 18 other states—an attempt to nullify the benefits that Delaware has chosen to grant as part of its carefully considered tax policy.

II. Delaware Is Constitutionally Entitled To Devise And Implement Its Corporate Tax Policies Without Encroachments From Other States.

Alabama disagrees with Delaware's corporate-tax policy. That much is clear. In its state court briefing, Alabama repeatedly (and pejoratively) referred to Delaware as a "tax-haven state"—presumably because Delaware has chosen not to impose certain taxes on businesses that would be subject to tax in Alabama. *See, e.g.*, Br. of Respondents 37, 45, 70, *Ex parte VFJ Ventures, Inc.*, No. 1070718 (Ala. Sup. Ct.); Br. of Appellants 15, 19, 42, 62, 69, *Surtees v. VFJ Ventures, Inc.*, No. 2060478 (Ala. Ct. Civ. App.). Alabama, of course, is free to disagree with Delaware's tax policy. Indeed, state-to-state disagreements about economic and social policy are the essence of federalism. As "laborator[ies]" of experimentation, individual states are entitled to make the important policy choices that affect their citizens. *New State Ice Co. v. Liebmann*, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting). Accordingly, within the boundaries of the Constitution and this Court's jurisprudence, Alabama can choose for itself whatever corporate tax policy it wishes.

What Alabama may *not* do is impose its own tax policy on Delaware. As an important corollary to his labor-

atory theorem, Justice Brandeis cautioned that states must make and implement their policy choices—conduct their experiments—"without risk to the rest of the country." *Id.* Accordingly, this Court has long recognized the fundamental principle that "[n]o State can legislate except with reference to its own jurisdiction" and that "[e]ach State is independent of all others in this particular." *Bonaparte v. Tax Court*, 104 U.S. 592, 594 (1881). The Court has repeatedly—and in a variety of contexts—reiterated this constitutional prohibition on "extraterritorial" state legislation. *See, e.g., State Farm Mut. Auto. Ins. Co. v. Campbell*, 538 U.S. 408, 421-22 (2003) (constitutional limitations on state punitive-damages awards); *BMW of North America, Inc. v. Gore*, 517 U.S. 559, 571-72 (1996) (same); *Phillips Petroleum Co. v. Shutts*, 472 U.S. 797, 821-23 (1985) (constitutional limitations on state choice-of-law rules); *Bigelow v. Virginia*, 421 U.S. 809, 822-23 (1975) (constitutional limitations on state advertising regulations); *New York Life Ins. Co. v. Head*, 234 U.S. 149, 161-65 (1914) (constitutional limitations on state insurance statutes).

Most significantly for present purposes, this Court has consistently enforced the anti-extraterritoriality principle in its dormant Commerce Clause cases. In *Healy v. Beer Institute*, for instance, the Court held that "the Commerce Clause protects against inconsistent legislation arising from the projection of one state regulatory regime into the jurisdiction of another State." 491 U.S. 324, 336-37 (1989) (citing *CTS Corp v. Dynamics Corp. of Am.*, 481 U.S. 69, 88-89 (1987)). The *Healy* Court observed that the anti-extraterritoriality principle "reflect[s] the Constitution's special concern" not only with "the maintenance of a national economic union unfettered by state-imposed limitations on interstate com-

merce," but also—and more importantly from Delaware's perspective—with "the autonomy of the individual States within their respective spheres." *Id.* at 335-36. *Healy* followed more than a half-century of this Court's Commerce Clause jurisprudence. *See, e.g., Brown-Forman Distillers Corp. v. New York State Liquor Auth.*, 476 U.S. 573, 583-84 (1986) (Commerce Clause prevents one state from "'project[ing] its legislation into [other states]'" (quoting *Baldwin v. G.A.F. Seelig, Inc.*, 294 U.S. 511, 521 (1935))); *Edgar v. MITE Corp.*, 457 U.S. 624, 642-43 (1982) (Commerce Clause violated where the "'practical effect of [a state] regulation is to control [conduct] beyond the boundaries of the state'" (quoting *Southern Pac. Co. v. Arizona*, 325 U.S. 761, 775 (1945))).

The Alabama add-back statute's extraterritoriality is clear. Even on its face, the statute constitutes an effort to impose Alabama's tax policy beyond its borders and, here, to "project[]" that policy into Delaware. *Healy*, 491 U.S. at 334. In relevant part, the add-back statute provides as follows:

> For purposes of computing its taxable income, a corporation shall add back otherwise deductible ... intangible expenses and costs directly or indirectly paid ... to ... one or more related members, except to the extent the corporation shows ... that the corresponding item of income was in the same taxable year: a. *Subject to a tax based on or measured by the related member's net income in Alabama or any other state of the United States* ....

Ala. Code § 40-18-35(b)(1) (emphasis added). Thus, under the statute, an Alabama corporate taxpayer can obtain a business expense deduction for royalty payments to a related company—a deduction to which it is otherwise entitled by law—*only if the payments themselves are taxed in the related company's home state.* If, as here, the state in which the related company is located has chosen *not* to tax royalty income, Alabama's add-back statute is triggered, resulting in additional tax liability for the Alabama taxpayer.

The Alabama courts' opinions below confirm the add-back statute's extraterritorial reach. In the course of attempting to deny that the statute unconstitutionally discriminates against interstate commerce, the Alabama Court of Civil Appeals (whose opinion the Alabama Supreme Court adopted as its own) observed—with emphasis—that "[t]he subject-to-tax exception of Alabama's add-back statute applies when the related member's income is taxed 'in Alabama *or any other State* of the United States.'" Pet. App. 62a (quoting Ala. Code § 40-18-35(b)(1)). Thus, the court said, "the subject-to-tax exception challenged by VFJ is implicated *regardless of which state imposes a tax* on the related member's income." *Id.* (emphasis added). But this is precisely the problem with Alabama's add-back statute. The related member's home state *must* "impose[] a tax" on the related member's royalty income. If it chooses not to, the Alabama taxpayer will suffer the add-back consequences.

The likely impact is clear: Alabama's add-back statute will "discourage[] Alabama corporations from entering into royalty agreements with related members located in [non-taxing] States" like Delaware or, for that

matter, "from setting up related members in non-taxing States" like Delaware in the first place. Pet. 19. For a state like Delaware, the disincentive created by the add-back is substantial. Were Lee and Wrangler located in a taxing state rather than Delaware, the Petitioner's "taxes in Alabama would decrease by about $1 million" for the 2001 tax year alone. Pet. 22. (Of course, the Petitioner's Alabama tax liability would also decrease if Delaware would "change[] its laws to tax the royalty payments made" to in-state companies like Lee and Wrangler. *Id.*) Multiply the disincentive created by Alabama's add-back statute by 19—the number of states that currently have such statutes (*see* Pet. App. 12a n.3)—and the consequences for Delaware's carefully considered and longstanding tax policies are dire.

Alabama and the other add-back states are picking winners and losers based on their own view of Delaware's and other states' tax policies. These states should not be permitted to undermine Delaware's policy judgments by imposing their own preferences through impermissible extraterritorial legislation.

III. This Court Should Resolve The Add-Back Issue Now.

The Petitioner has explained why prompt review of the Alabama Supreme Court's decision is important both to corporate taxpayers and to the 19 states that have enacted add-back statutes. *See* Pet. 3-4, 25-31. The taxpayers' interest in a quick decision is clear: They are presently being subjected to substantial taxes under statutes that they contend are unconstitutional. The taxing states' interest in speedy resolution is just as significant. Should this Court eventually hold that add-back statutes

like Alabama's violate the Commerce Clause, taxing states will likely have to pay out refunds on a retrospective basis. *See, e.g.*, *McKesson Corp. v. Division of Alcoholic Beverages & Tobacco*, 496 U.S. 18, 31-36 (1990). "The longer States continue enforcing add-back statutes, the more States may eventually be forced to refund." Pet. 30. These "enormous potential refund liabilities" could wreak havoc with taxing states' budgetary assumptions. *Id.* Thus, as the Petitioner contends, "prompt resolution of this issue would benefit not only taxpayers, but also the States that have adopted [add-back] statutes and other States that may follow suit." *Id.*

While Delaware is differently situated, it too needs clarity now. Should this Court wait to address the constitutional question that these add-back statutes present, Delaware could well suffer irreparable harm in the meantime. As already explained, Delaware's policy decisions have for years successfully attracted businesses with, among other things, comparatively lower taxes. Should this Court allow the Alabama Supreme Court's decision to stand—thereby approving, at least on an interim basis, Alabama's add-back policy—companies presently based in Delaware could choose to organize elsewhere. Likewise, companies may decide that the benefits of Delaware's tax policy are too uncertain to justify organizing in Delaware in the first instance.

Surely the Petitioner, for example, would prefer to see Lee and Wrangler located in Alabama (or some other taxing state) to relieve its add-back tax obligation. Because, like a number of other add-back states, Alabama does not impose an add-back penalty on the portion of royalty-related payments on which the recipient actually pays *any* tax, the rational business decision would be to

relocate Lee and Wrangler out of Delaware to the state that imposes the smallest tax greater than zero. Especially in light of the current volatility of the national economy, Delaware's concerns about losing a significant sector of its corporate base are warranted, as companies may choose to relocate rather than stay in Delaware while this Court allows the add-back issue to percolate.

It is unlikely that even a favorable decision in some later case could undo the damage. The companies that had relocated to other states, for instance, might not all return to Delaware. Even if a number of them did, Delaware would have lost the benefit of having those companies in-state in the interim. Most troublingly, by the time this Court stepped in to remedy the situation, Delaware may already have been forced, as a result of the extraterritorial reach of these add-back statutes, to alter its own corporate tax policy in fundamental ways—through nominal taxes aimed at thwarting add-back statutes, tax credits, or otherwise. Because this Court's dormant Commerce Clause jurisprudence recognizes that this sort of interstate back and forth does lasting damage to the federal union, this Court should address the add-back issue now.

Clearly, Delaware has a position on the merits here: It believes that add-back statutes like Alabama's (1) impermissibly reach across state borders in an effort to influence Delaware tax policy and (2) inherently discriminate against interstate commerce in ways prohibited by this Court's case law. Having said that, Delaware's current concern is that the Court resolve the add-back issue—one way or the other—imminently. For reasons already explained, an affirmance would prejudice Delaware's historical, and successful, policy judgments. Nev-

ertheless, an affirmance would permit Delaware to go forward with some level of certainty, knowing that it would need to account for the add-back phenomenon. As matters stand now, the add-back issue is in a state of legal limbo—to the detriment of Delaware's fiscal policymakers and Delaware's businesses, neither of which can adequately plan for the future.

CONCLUSION

This Court should grant the petition for certiorari.

Respectfully submitted,

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